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THE TORONTO ECONOMIC SUMMIT:

GREAT EXPECTATIONS NEED TO BE TEMPERED WITH REALISM

by

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Each year, the Economic Summit meeting raises expectations among some onlookers of fundamental solutions to the world's economic problems. As the seven leaders of the major industrialized countries gather in Toronto for the fourteenth Economic Summit, 4,000 of the world's press and other media representatives will also attend, focusing the world's attention on the event and again tending to raise expectations about what the leaders are likely to achieve.

One reason for the media attention is that the Economic Summit is the most visible event in a regular series of meetings that attempt to maintain international consultation and cooperation on the fundamental issues of the world economy. The other international fora include meetings of the International Monetary Fund (IMF), the World Bank, the General Agreement on Tariffs and Trade (GATT), the Organisation for Economic Co-operation and Development (OECD), and the Group of Seven (G-7) finance ministers and central bankers.

The first Economic Summit, held in France in 1975, was stimulated by two key concerns of the mid-1970s: the breakdown of the Bretton Woods system of fixed exchange rates and the effects of the oil price crisis of 1973-74, which had resulted in spiraling inflation and an economic recession.

At this first meeting, the leaders made a commitment to hold regular summits to discuss current world economic issues. It should be remembered that the summits are <u>not</u> meant to be a decisionmaking process; their underlying aim is to provide an opportunity for the leaders to reach a better level of understanding of each other's situations and to work together to set the tone and the agendas for the meetings of other international agencies.

The Toronto Summit Agenda

Over the past year, much planning and background research has gone into the Toronto Economic Summit. The leaders' "summit sherpas" have undertaken most of these endeavors, with Canada's lead sherpa, Dr. Sylvia Ostry, holding the key coordinating responsibilities. Through regular meetings, the sherpas have expertly designed the agenda and background materials so that, between June 19 and June 21, the seven leaders can partake in meaningful discussions. The agenda has not been published, but the appropriate topics for discussion are:

- the sustainability of noninflationary growth;
- macroeconomic policy coordination;
- the Uruguay Round of GATT negotiations;
- world debt;
- longer-term economic issues; and
- political issues.

This Commentary focuses attention on these six broad topics.

The Sustainability of Noninflationary Growth

When the leaders met a year ago in Venice, a key issue was the distinct possibility of the emergence of an economic slowdown, and they expressed concerns about averting a recession. A year later, the world economy continues to grow in spite of the October 19, 1987, stock market correction, and the business expansion that began in late 1982 marches on.

Discussions in Toronto will focus on the reasons for the inherent strength of the world economy, the sustainability of the expansion, mounting concerns of renewed inflation, and the possibility of an abrupt end to this long period of economic expansion in 1989.

It is likely that the leaders will agree unanimously that the inflation spiral of the 1970s must be avoided and, in particular, that the current inflation pickup in both the United States and Canada must be contained. (In North America and the United Kingdom, inflation is running about 3 percentage points higher than in Japan and West Germany.) The leaders will thus emphasize maintaining the expansion while containing inflation -- a particularly important focus during a U.S. election year when no major new policy initiatives can be expected. Canada's prime minister will join the other leaders in endorsing this approach, particularly since his party also faces an election sometime in the next 12 months and he clearly would prefer to fight it while the North American economy is still expanding.

Macroeconomic Policy Coordination

Over the past several years, policymakers have focused their attention on the feasibility and benefits of macroeconomic policy coordination. The underlying reasons for this were the emergence of the large U.S. budgetary deficit in the 1980s, exchange-rate volatility, and sizable trade imbalances between the United States and its major trading partners: Japan, West Germany, the newly industrializing countries (NICs), and Canada.

There has been some progress on these issues over the past year. The U.S. budget deficit, for example, dropped from a high of $225 billion in 1986 to $150 billion in 1987, although further progress beyond the Gramm-Rudman guidelines will not occur until after a new president has been elected.

In recent months, a consensus has begun to emerge that the United States' current dollar trade gap is now clearly narrowing. This news has reinforced what thoughtful students of the real, or constant dollar, trade gap have been saying for some time. The real trade gap, which reached its worse point in late 1986, improved steadily in 1987, and U.S. real exports rose by 30 percent last year.

Recent data indicate that imports, at long last, also appear to be flattening out. The combination of a rise in import prices, a buildup of import inventories, and a slowdown in consumption spending seems to indicate that the months ahead will see imports retreat.

There is clear evidence that the U.S. trade deficit with Japan, West Germany, and the United Kingdom is improving. Japan once again has proven its ability to adjust to external forces by encouraging domestic consumption and by refocusing industries. It has reduced its exports to the United States and increased its imports, and the trade gap between the two countries has been narrowing for 12 consecutive months. There is still a way to go, however; Japan is still running a sizable trade surplus with the United States, even after increasing its imports from the United States by about 50 percent.

Europe is a different story. The United States wants West Germany, in particular, to stimulate domestic consumption by tax and interest-rate cuts. Faster growth in West Germany is recognized as the key to faster growth throughout Europe. To date, however, West Germany has resisted expansionary policies for reasons that run deep in its postwar economic history. West Germany -- as well as the Scandinavian countries -- has built its economy on exports. For Europe now to absorb $75 billion more in U.S. goods and services will not be easy.

Although many Europeans now believe that this correction is desirable, they also rightly state that Europe is not Japan, and that a swing of this magnitude represents a major adjustment -- many times larger than the oil shocks of the 1970s. In contrast to Japan, where domestic demand can be increased through projects to improve housing and water systems, Europe's infrastructure is well developed, and European consumers already enjoy a relatively high level of consumer expenditures. Expansion within Europe, therefore, will be more difficult to achieve, and Europeans are uncertain how to do it without falling into the recession trap. Therefore, they are calling for gradualism, with a year-to-year adjustment of $15-20 billion in their trade deficit with the United States. This could mean a further depreciation of the U.S. dollar against major European currencies, particularly the deutschemark.

The U.S. trade adjustment also has implications for the NICs, particularly the four Asian "tigers" of South Korea, Taiwan, Hong Kong, and Singapore. In 1987, these countries' combined trade surplus with the United States was close to $40 billion. In order to avoid the risk of U.S. retaliation, they will have to rely less on exporting to the United States and let their currencies rise against the U.S. dollar. This implies slower export-led growth for these NICs or a shift to stronger domestic demand growth.

Canada ran a large, $12.9 billion bilateral trade imbalance with the United States in 1987; in fact, during the first three months of 1988, the deficit widened still further as U.S. demand for Canadian resource products rose.

In 1987, the United Kingdom, France, and Italy all chalked up domestic demand growth rates of 3.5-4.5 percent, while Japan's was 6.0 percent. West Germany recorded a slower, 2.5 percent growth rate, but recent data indicates that its rate of domestic demand growth is increasing. If these rates of growth continue, the industrial countries will make further progress in addressing their trade imbalances.

At the Toronto Summit, the leaders may note the achievements of the past year and encourage each other to continue to pursue cooperative economic policies. But not much more can be achieved in 1988 under the shadow of the U.S. election. The key goal of this Summit should be to discuss how to maintain the expansion while funding U.S. capital needs.

The leaders will also likely pay careful attention to the wording of the statement on exchange-rate stabilization. They will likely avoid a communiqué in the vein of the Louvre Accord of February 1987, which attempted to stabilize exchange rates at levels that were not in line with how financial markets viewed the world. The Summit statement likely will repeat the commitment the G-7 finance ministers and central bankers made at their meeting in April:

> to continue to coordinate economic policies to strengthen the underlying fundamentals and thereby reinforce the conditions for exchange rate stability.... [E]ither excessive fluctuations of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process, could be counterproductive by damaging growth prospects in the world economy. The Ministers and Governors also re-emphasized their common interest in stable exchange rates among their currencies and agreed to cooperate closely in monitoring and implementing policies to strengthen underlying economic fundamentals to foster continued stability of exchange rates.

At the Toronto Summit, emphasis likely will shift from macro coordination to microeconomic policies. Gaining wider acceptance is the idea that each G-7 country should adjust its domestic economy to respond to the competitive, global realities of the 1990s. To do so would require each of them to push forward with an appropriate microeconomic policy adjustment package involving tax reform, deregulation, privatization, and deficit reduction. If each country carries out these adjustments clearly and successfully, it will be economically stronger and better able to work cooperatively with other countries in the world of the 1990s.

The Uruguay Round of GATT Negotiations

It is against this backdrop that the relevance and importance of the Uruguay Round of the GATT becomes clear. This current round of multilateral trade negotiations will reach its halfway point at the GATT meeting in Montreal in December. At that meeting, it will be important for the GATT members to demonstrate that their discussions are materially advancing if they are to make progress in subsequent negotiations toward resolution of key issues such as agricultural subsidies, trade in services, intellectual property, and trade dispute settlement mechanisms.

In recent months, some progress has been made on the agricultural issue. In particular, the major players have now agreed on a definition of subsidy and have begun to recognize the damage that subsidies are causing. It is also true, however, that the United States and the European Community remain far apart on how and at what pace subsidies should be reduced. More progress is needed and this will require leadership. Unfortunately, recent changes in supply and demand conditions in world agriculture mean that many of the countries represented at the Summit will have to reduce the size of their agricultural sectors, a move that could have adverse domestic political consequences.

At the Toronto Summit, the seven leaders should renew their commitment to the success of the Uruguay Round and, thereby, to the principle of liberal international trade. This will require an agreement of some substance -- for example, to work toward a resolution on agricultural subsidies -- that other GATT participants would perceive as a major step forward.

World Debt

World debt has been on the agenda of each of the past several Economic Summits, but the problem continues to worsen in current dollar terms. In 1987, the de-

veloping countries' total external debt load was U.S.$1,211 billion, up from U.S.$634 billion in 1980. One-third of this debt is concentrated in South America, while Africa accounts for $179 billion, Asia for $293 billion, the Middle East for $164 billion, and the developing countries of eastern and southern Europe for $154 billion. The commercial banks have increased their write-offs and loan loss provisions for this debt, and some developing countries are increasingly able to grow out of their debt. With few exceptions, however, the ratios of external debt to exports and interest payments to exports are still troublesome and show little, if any, improvement. This deteriorating situation has occurred during a period of strong economic expansion and underlines the need to keep the world economy growing.

At the Summit, discussion of world debt is expected to focus on two key areas: Africa and the middle-income developing countries, most of which are in South America.

In Africa, some progress on the debt is possible. Following last year's Summit discussions, some creditors agreed to forgive some of the debt of the poorest countries of sub-Saharan Africa. Canada, for example, announced at the Commonwealth and Francophone Summits that it would forgive the Official Development Assistance debts of 13 of these countries. Discussions at the Toronto Summit likely will focus on getting other G-7 members, particularly France, to follow Canada's lead and also to support the World Bank's efforts to assist the poorest countries. This appears to be an appropriate strategy, since the poorest countries, in spite of good intentions, show little prospect of dealing with their debt problems without assistance.

The debt of the middle-income developing countries is a much more difficult issue, since it involves taxpayers and bank shareholders in the industrialized countries, who are being asked to bail out governments in these debtor countries. Since the last Summit, emphasis has been placed on the Baker Plan, which would have the middle-income developing countries reduce their debt ratios through economic growth. The Toronto Summit likely will endorse the Baker Plan, but discussions are likely to focus more on how to achieve debt reduction. Since many of these countries -- particularly Argentina, Brazil, and Mexico -- are resource rich, emphasis should be placed

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on meeting their debt-financing requirements while ensuring that they work toward improving the management of their domestic economies. In particular, this means increasing domestic savings and reducing the flight of capital.

Longer-Term Economic Issues

At the Toronto Summit, the agenda will include, for the first time, discussion of longer-term issues that need to be addressed if the G-7 countries are to be competitive in the new global environment. Specific items on the agenda will include the demographic profiles of the industrialized countries, competitiveness, and the environment.

Of fundamental concern to the G-7 countries are the implications of their aging demographic profiles. Their greying populations will mean severely reduced labor supplies, changes in market demand, and substantially increased demand for health care and social services. In all of these countries, as the number of dependants rises and the number of contributors to social programs falls, the cost of funding pension liabilities and supplying social services will rise. This will raise questions of how to finance such programs. Demographic changes will also affect these countries' policies on education, training, and immigration.

The issue of international competitiveness is already dominant in the G-7 countries as they attempt to meet the challenge of the NICs in the global marketplace. Specific items likely to be discussed at the Summit are education and training, technology, and innovation.

Finally, world environmental issues also will receive attention, including the need to control acid rain and other atmospheric pollutants. World health issues, such as AIDS likely will be discussed as well.

Political Issues

Although this will be an Economic Summit, a number of political issues will influence the discussions and form part of the agenda. U.S. President Reagan, for example, undoubtedly will want to discuss with the other leaders his just-completed Summit meeting with Soviet General-Secretary Gorbachev and to encourage their sharing of East-West responsibilities. The leaders may also discuss the issue of joint ventures with the Soviet Union, which are increasing rapidly. There are also likely to be discussions on the usual array of regional-political issues such as South Africa, the Middle East, and Central America.

Another important element of these discussions should be the treatment of the now-maturing NICs, particularly those on the Pacific Rim. Increasingly, the industrialized countries are calling on these NICs to play a more active and responsible role in global affairs. The NICs are not members of the OECD "club", however, which makes official dialogue with them more difficult. Some method needs to be developed to facilitate dialogue with these countries. An increasingly important political consideration is the role and membership of international institutions. This is linked to the twin forces of globalization and the increasing economic power of the NICs, which make it increasingly important to monitor developments in the international trading system. Put another way, just as finance ministers meet annually in the IMF forum, trade ministers need to meet on a regular basis under GATT auspices to monitor developments in international trade and trade policy. NICs that are playing an increasing role in world trade should attend such discussions to participate more fully in resolving the economic issues of the 1990s and thereby work toward mutually acceptable resolutions of common problems.

Conclusion

As the Toronto Economic Summit begins, it is important that we set realistic expectations about what progress can be made to resolve the complex set of world issues the leaders will address. These Summits were not designed as a decisionmaking vehicle but to facilitate discussion and cooperation. With that in mind, the success of the Toronto Summit should not be measured by the number of concrete decisions the leaders take.

The first priority of this Summit is to foster continuing dialogue and cooperation among the seven countries, which means underlining the need and usefulness of maintaining regular meetings.

The most visible sign of success or failure of the Toronto Summit will be the official communiqué. The Summit can be regarded as a success if the leaders agree:

- on the need for further progress in correcting major international trade imbalances and commit to pursue domestic policies that will aid in their reduction;
- to pursue noninflationary growth strategies with the joint aim of sustaining the current expansion;
- to pursue micro structural adjustments of their economies as they prepare to meet global competitive challenges;
- to provide fresh and forceful impetus to the Uruguay Round -- in particular, by rededicating themselves to reducing agricultural subsidies;
- to establish some basis for dealing with the debts of the poorest of the developing countries;
- to re-emphasize the debt problems of the middle-income countries and to provide additional assistance in conjunction with the Baker Plan; and
- to begin to focus on some common longer-term economic issues on which future cooperation may prove necessary.

If the seven leaders can agree on these points in a U.S. presidential election year, then the Toronto Economic Summit will have been a success, and Canada will have laid the groundwork for international dialogue in the year ahead.

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